IN THE

SUPREME COURT OF THE UNITED STATES

No. .....

PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1960.

No. .....

O. D. BRATTON and DOROTHY BRATTON, J. ROSS HOLCOMB, JR., FRANK A. CONKLING and EULA W. CONKLING, JAMES A. HOLCOMB and LOU H. HOLCOMB, and MRS. NOLAH D. HOLCOMB,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

To THE HONORABLE, THE CHIEF JUSTICE OF THE UNITED STATES AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Petitioners pray that a Writ of Certiorari issue to review the judgments of the United States Court of Appeals for the Sixth Circuit entered in the above cause.

OPINIONS BELOW.

The opinion of the Tax Court of the United States is reported at 31 T.C. 891 (1959) and a copy of which is attached hereto in the Appendix at pages A1-A17. The *per curiam* opinion of the United States Court of Appeals for the Sixth Circuit is reported at 283 F.2d 257. A copy of said opinion is appended to this Petition in the Appendix at pages A18-A20.

JURISDICTION.

The judgment of the Court of Appeals for the Sixth Circuit was rendered and entered on October 31, 1960, and a copy of said judgment is attached in the Appendix at page A21. An extension of time having been obtained, a Petition to Rehear was filed with said Court on December 1, 1960. The Petition to Rehear was denied without opinion on December 6, 1960. A copy of said order is attached hereto in the Appendix at page A22. Thereafter, the mandate of said Court issued, a copy of said mandate is attached in the Appendix at pages A23-A24.

It is by the judgment of the Court of Appeals for the Sixth Circuit embodied in this matter, together with the opinion rendered in support thereof, that petitioners are aggrieved and of which they now seek review in this Court.

Jurisdiction of this Court is envoked under Title 28, Section 1254 of the U. S. Code, reading in part as follows:

> "Cases in the Court of Appeals may be reviewed by the Supreme Court by the following methods:
>
> (1) By writ of certiorari granted upon the petition of any party to any civil or criminal case before or after rendition of judgment or decree;"

QUESTIONS PRESENTED.

The petitioners, cash basis taxpayers, were both creditors and stockholders in Hobac Veneer & Lumber Co., a Tennessee corporation, herein called "Hobac".

After the death of the principal manager of Hobac in 1951, the corporation began to lose money and a controversy arose among petitioners, as stockholders, in regard to the further operations of Hobac. This controversy was in large part due to the fact that Hobac was indebted to the petitioners, as creditors, in varying amounts. This indebtedness to petitioners represented commissions and salaries which had accumulated for a number of years. Hobac had not been able to pay the petitioners for their commissions and salaries when incurred since such indebtedness was subordinated to a loan obtained from the Union Planters National Bank of Memphis, Tennessee, herein called "Bank".

The questions presented are:

(1) Does a corporation have the right to satisfy its creditors by substituting the indebtedness of third parties to the corporation for the indebtedness of the corporation to its creditors?

(2) Does the consent by the creditors to the action of the corporation to such an arrangement constitute taxable income to the creditors as of the date of such consent?

(3) Can there be constructive receipt of income by petitioners, as creditors, when there is no unconditional title to such income as a matter of right?

STATUTES, FEDERAL RULES AND REGULATIONS INVOLVED.

The pertinent provisions of I.R.C. (1939), Section 22, formerly 26 U.S.C., Section 22, and Treasury Regulations, Regulation 118, Sec. 39.42-2, are set forth in the Appendix at pages A25-A26.

STATEMENT.

References prefixed by the letter "R" are to pages of the certified record of the Court of Appeals filed herein. References prefixed by the letters "App." are to the pages of the Appendix attached to this Petition.

The proceedings in these cases were consolidated for hearing in the Tax Court of the United States (R. 97) and were consolidated for review in the Court of Appeals for the Sixth Circuit. This Petition for Certiorari is filed herein on behalf of all petitioners. Original jurisdiction of the Tax Court is based on the provisions of I.R.C. (1954), Sec. 7442, 26 U.S.C., Sec. 7442. The petition for review of the decisions of the Tax Court was filed pursuant to the provisions of I.R.C. (1954), Sections 7482, 7483, 26 U.S.C., Sections 7462 and 7463.

Respondent, Commissioner of Internal Revenue, determined deficiencies in petitioners' income tax returns for the years 1952 and 1953. The alleged deficiencies resulted from petitioners' claims as creditors in Hobac being satisfied as to Hobac by the assumption of such indebtedness by third parties who were themselves indebted to Hobac (R. 5-12).

Hobac was engaged in the manufacture of lumbers and veneers (R. 99). Its assets for the year in question, 1952, consisted of a plant and mill located in Caruthers-

ville, Missouri; an inventory of logs, veneer, finished lumber, and timber lands (R. 99, App. A4). During the same period, its liabilities consisted of indebtedness to the Bank which was secured by a mortgage; accumulated salaries and commissions to the petitioners, and outside indebtedness of approximately $25,000.00 (R. 69, 100, App. A4). These unpaid commissions and salaries had accumulated over a period of years due to the fact that the funds of Hobac had been used to pay the indebtedness to the Bank. The "Term Loan Agreement" executed by Hobac with the Bank had expressly subordinated such future salaries or commissions to the Bank's indebtedness (R. 100).

Petitioners Conkling and Bratton, each owned a twenty-five (25%) per cent interest in the capital stock of Hobac. Petitioners, Nolah D. Holcomb, J. Ross Holcomb, Jr., and James A. Holcomb, succeeded equally to the twenty-five (25%) per cent interest of J. Ross Holcomb, Sr., deceased. The remaining twenty-five (25%) per cent interest in Hobac was owned by James T. Ahearn, who is not a party to these proceedings (R. 99).

J. Ross Holcomb, Sr., had actively managed the affairs of Hobac until his death in 1951. Thereafter, the business was managed by James T. Ahearn, whose affairs in 1952 would not permit him to continue to be charged with the responsibility of the operation of Hobac (R. 100, App. A4).

In 1951, when it appeared that Hobac would sustain an operating loss, the Holcomb heirs became desirous of realizing on their inherited holdings. Petitioners, Bratton and Conkling, were at that time undecided as to what should be done with Hobac (R. 101, App. A5). When a purchaser for all the stock of Hobac could not be found, considerable dispute arose between the stockholders in

regard to the manner in which Hobac could be sold or liquidated. Several plans were offered and rejected before the following transactions occurred which ultimately led to the dissolution of Hobac (R. 34-38, 40, 42-43, App. A5).

In September of 1952, Hobac sold its finished lumber for cash (R. 101). The best offer Hobac could obtain for its mill and related properties was an offer from Betz and Tipton, dba Betz-Tipton Veneer Co., herein called "Betz-Tipton", to buy such mill and related properties for long-term notes with no cash down payment (R. 36). Such offer was reduced to an Agreement on December 18, 1952, in which Agreement Betz-Tipton agreed to assume the indebtedness owed by Hobac to petitioners, as creditors, with said indebtedness to be payable from the proceeds of the long-term notes issued by Betz-Tipton to Hobac. Petitioners, as creditors, accepted such Agreement and agreed to look to Betz-Tipton for payment of their indebtedness and released Hobac from any further claims arising out of such indebtedness (R. 74-77, App. A6). The remaining inventory was then sold by Hobac to Betz-Tipton for a demand note which was also made a part of the Agreement of December 18, 1952 (R. 77-79).

It is important to note that these promissory notes were stated to be negotiable in the opinion of the Tax Court (R. 112, App. A16). This is in direct conflict with the terms of the notes which are set out in the Findings of Fact of the Tax Court which show that such notes were not negotiable, not having been payable "to order of" or "to bearer" (R. 104-105, App. A9).

The Union Planters National Bank agreed to act as pledgee of the notes given by Betz-Tipton in an agreement executed on December 20, 1952, between the Bank, Hobac and petitioners, as creditors of Hobac. The terms of the

Pledge Agreement provided for payment of Hobac's indebtedness to Bank from the promissory notes and thereafter the petitioners, as creditors, were to receive payments for their claims (R. 79-84, App. A9). On the same date, the written consent of the Bank to proceedings necessary to liquidate Hobac was obtained. This consent was necessary under the terms of the Term Loan Agreement executed by the Bank and Hobac (R. 84-89, App. A4).

Promptly following the Bank's execution of the "Consent to Liquidation", a formal joint meeting of the Stockholders and Directors was held. The minutes of this meeting show that the sales to Betz-Tipton had been approved and that Hobac had been released and discharged from further liability to its creditors. At this meeting for the first time a resolution was proposed and adopted authorizing liquidation of Hobac and distribution of Hobac's timber lands to the stockholders of Hobac for their capital interests (R. 89-94). The timber lands were then distributed in 1952 to the stockholders, as a partial distribution, for their capital interests; and thereafter, in 1953, the remaining assets were distributed and the Charter of Incorporation was surrendered on October 1, 1953 (R. 106, App. A10).

The amounts realized from the sale of timber lands by petitioners were included in their 1952 returns as amounts received as a partial distribution on their stock, and the difference between these amounts and the cost of their stock was reported as gains from the sale of capital assets. The sums distributed from year to year to petitioners, Bratton and Conkling, from collections on deferred purchase money notes have been treated as ordinary income in the year in which received and this approach is now being urged upon the Court by all petitioners (R. 106-107, App. A11).

The Tax Court concluded in its decision that petitioners received both the timber lands and the Betz-Tipton notes during 1952 by way of distributions in liquidation. To the extent of the petitioners' claims as creditors, these distributions would then represent ordinary income with the remainder to be applied against petitioners' capital interests (R. 113-114, App A17). The Court of Appeals in its *per curiam* opinion affirmed the decisions of the Tax Court on the basis of such conclusion (R. 130-131, App. A19).

REASONS FOR GRANTING THE WRIT.

The Court of Appeals for the Sixth Circuit in affirming, *per curiam*, the opinion of the Tax Court held that petitioners constructively received income in the year 1952 (R. 130-131, App. A20). By so doing, the Court of Appeals has extended the doctrine of constructive receipt of income far beyond the boundaries set forth in the decisions of other Circuits of the Court of Appeals and beyond the limitations contained in the Regulations issued by the Treasury Department. See Reg. 118, Sec. 39.42 (1939) (App. A26).

In its opinion, the Court of Appeals summarized the contentions of the parties and the holding of the Tax Court as follows:

> "The real dispute, between the parties relates to the manner in which the notes should be treated for tax purposes. Taxpayers claim that the notes should not be considered as a distribution in cash and that they should be taxed only on the actual installments paid on the notes as and when received by them from the bank. Taxpayers insist that the notes were never delivered to them and that they have neither title to or possession of the notes.

The Commissioner on the other hand maintains that the notes should be taxed at their full face value in 1952, at the time when they were transferred to the bank.

The Tax Court determined that the transfer of the notes to the bank was in reality for the benefit of the taxpayers and that the bank in collecting the installment payments and distributing them to taxpayers was acting as their agent. The Tax Court further held that the notes should be taxed at their full face value at the time of the assignment to the bank since there was no proof that their fair value was any less, citing *Loyer* v. *Commissioner*, 199 F.2d 452 (C.A. 6, 1952)."

Bratton et al. v. *Commissioner*, *supra*, 283 F.2d at p. 258.

(R. 130; App. A19.)

The conclusion of the Court that acts done by Hobac which might benefit petitioners, in their capacity as creditors of Hobac, is an unusual basis for imputing constructive receipt of income to a taxpayer. The undisputed facts were that Hobac owned long-term promissory notes which carried no terms of negotiability such as "to order of" or "to bearer" (R. 112, App. A9). These notes were never conveyed, transferred or assigned to petitioners, either in their capacity as creditors or stockholders of Hobac. They were placed in an escrow account with the Bank under a Pledge Agreement whereby the proceeds from the notes were to be held by the Bank until such time as the Bank's indebtedness had been paid in full and thereafter the proceeds were to be distributed to petitioners for their claims as creditors of Hobac (R. 79-84, 104, App. A9).

No one of the petitioners had any right in any capacity to demand possession of the notes from the Bank. Under the terms of the Pledge Agreement, the Bank had

the sole right to bring any action on the notes. The indebtedness due petitioners was expressly subordinated to the Bank, as pledgee, "until those indebtednesses shall have been paid in full" (R. 80, 105, App. A9). The trust deed which secured payment of the pledged notes was subject to a pre-existing mortgage in favor of the Bank (R. 81).

With these undisputed facts, it became a problem for the Tax Court to determine in what manner petitioners, as creditors had received income in the year 1952. The respondent presented several theories to the Tax Court. The original position of the respondent, which is set forth in its ninety-day letters to petitioners, was virtually abandoned in the Tax Court. At the conclusion of the hearing in that case, four alternative theories were made part of the respondent's answer (R. 20-24). The theory which was accepted by the Tax Court and affirmed by the Court of Appeals is as follows:

> "(b) Respondent alleges in the alternative that if the Court should determine that the petitioner pursuant to the liquidation of the corporation received both the interest in the timber lands and the interest in the collateral pledge agreement involving the Betz-Tipton notes in the year 1952, then the petitioner received in the year 1952, payment in full of the compensation owed by the corporation, taxable as ordinary income, and liquidating dividends entitled to capital gains treatment. Since respondent in his notice of deficiency determined that petitioner received full payment of the compensation owed him by the corporation in 1952, and received part of the liquidating dividends in 1952, and the balance in 1953, a finding by the Court that both full payment of the compensation and receipt of liquidating dividends occurred in 1952, will result in additional income and an increased deficiency for the year 1952."
>
> (R. 22, 108, App. A12.)

Since it was not denied that petitioners never received the promissory notes payable to Hobac and in no way owned them, the Tax Court concluded that the petitioners had constructively received the promissory notes during the year 1952 (R. 113, App. A16). This finding is in direct conflict with the Regulations propounded by the Treasury Department and which have been in effect since 1918. On familiar principles, these Treasury regulations of over forty years' standing possess the force of law. *Boehm* v. *Commissioner*, 326 U.S. 281 (1945). Such regulations require that a taxpayer have, in effect, the income set aside for him and payable at his will, without substantial limitation, before such income can be held to be constructively received by him (App. A26).

What the Court meant when it stated that the Bank was acting for the benefit of petitioners is unknown, but certainly such reason does not make the Bank the agent of petitioners. What control could the petitioners, as principals, exercise over the Bank as their agent as required by Tennessee law? *National Cash Register Co.* v. *Leach*, 3 Tenn. App. 411 (1926). By what contract or course of action did a contract arise between petitioners, as creditors, and the Bank which would create a principal-agent relationship. *Prater* v. *Fidelity Trust Co.*, 161 Tenn. 626, 34 S.W.2d 205 (1930). None of the relationships required by the law of Tennessee existed between the Bank and petitioners which would form a principal-agent relationship.

This Court has held in *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950), that Congress has determined that different tax consequences shall flow from different methods by which the stockholder of a closely held corporation may dispose of its corporate property. It follows that Hobac may satisfy the claims of its creditors,

even if they be shareholders, in such manner as would be acceptable to the interested parties, even if this results in the creditors accepting postponement of receipt of the payments to be applied on the indebtedness.

A creditor may even voluntarily relinquish amounts due by a corporation without incurring a tax liability. See *John Harvey Kellogg* v. *Commissioner*, 2 T.C. 1126 (1943).

In *McLaughlin* v. *Commissioner*, 113 F.2d 611 (7th Cir., 1940), the Court of Appeals for the Seventh Circuit was faced with a similar situation. There notes given for the purchase price of corporate stocks and the stock were deposited with an escrow agent by the seller and the purchaser. The escrow agent was authorized to collect the notes and deliver the stock to the makers of the notes. The first of the purchase money notes was paid in full in 1931, the year in which the sale took place. The Commissioner treated all the remaining notes which were due in subsequent years as income to taxpayer and his associates in 1931 and asserted a deficiency.

The Court of Appeals ruled in favor of the taxpayer, stating that the decisions which have held that the receipt of notes constitutes a receipt of income rests upon the factual conclusion that the notes are for all practical purposes equivalent to cash. The Court said that in no practical sense can a promissory note be said to have cash equivalence to the payee if the payee had no power of sale or, at least, the power to pledge the note as security for a loan. The Court pointed out that the payee not only did not have actual control or custody of the notes, but under the escrow agreement he was without legal power to obtain possession of the notes or in any manner utilize them for business purposes.

It seems that every contention advanced by the Commissioner and every reason given by the lower courts were urged upon the Court of Appeals in the McLaughlin case. That Court answered each and every of the Commissioner's contentions in favor of the taxpayer. These petitioners urged the holding in the McLaughlin case upon the lower courts. It is safe to assume that, not being able to distinguish the McLaughlin case, the Court of Appeals and the Tax Court simply ignored it.

It has been held that money paid in escrow pending discharge of a tax lien does not constitute constructive receipt of income. *Sloane* v. *Commissioner*, 188 F.2d 254 (6th Cir., 1951). Nor has there been constructive receipt in the year money was deposited in Court as compensation for property taken by condemnation. *Nitterhouse* v. *United States*, 207 F.2d 618 (3rd Cir., 1953), cert. den. 347 U.S. 943. Relying on the Regulations, as its authority, the Court in *Commissioner* v. *Carpenter*, 219 F.2d 635 (5th Cir., 1955), held that it is fundamental in income taxation that before a cash basis taxpayer may be charged with the receipt of income, the taxpayer must receive cash or property unqualifiedly subject to his demands.

Associate Justice Stewart, while a member of the Court of Appeals for the Sixth Circuit, recognized the right of taxpayers to so arrange their affairs that where there are two methods of procedure, one of which may result in a greater tax liability than the other, the taxpayer may choose the method which would result in the lower tax liability. The language of Justice Stewart is as follows:

> "It is true that the syndicate members could have achieved their objective, yet completely avoided the tax liability here imposed, simply by their purchase of the two hundred shares owned by the minority

shareholders, followed by Buckeye's redemption of all Mrs. Derby's stock. We can assume that if the transaction had been cast in that form neither petitioners nor Mrs. Derby would have been charged with the receipt of ordinary income. Cf. Zenz v. Quinlivan, 6 Cir., 1954, 213 F.2d 914."

Woodworth v. *Commissioner*, 218 F.2d 719 at 724 (6th Cir., 1955).

As if to bolster the basis of the opinion of the Tax Court, the Court of Appeals held that in any event the decisions of the Tax Court could be justified on the grounds of novation; that is, the substitution of a new debtor in place of an old one. The Court then cited Tennessee cases which purportedly held that such novation constituted payment and discharge of the indebtedness.

These cases, *Southworth* v. *Thompson*, 57 Tenn. 10 (1872), and *Union Bank of Tennessee* v. *Smiser*, 33 Tenn. 501 (1853), do give support to the theory of novation as being a method of discharging indebtedness but neither case gives any indication that the acceptance of a new debtor in place of an old debtor constitutes income within the meaning of I.R.C. (1939), Section 22. It is respectfully submitted that in no event could such cases be cited as authority that the acceptance of a new debtor in place of an old debtor constituted income within the meaning of the above code section.

The petitioners contend that such a novation did in fact exist to the extent that one debtor was substituted for another debtor, but that such substitution did not constitute receipt of taxable income to petitioners.

The decision of the Court of Appeals in affirming the Tax Court opinion which relied on the principle espoused in *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945), that substance rather than form controls the tax effect of

transactions, and which has been lately amplified in *Knetsch* v. *Commissioner*, ... U.S. ....., 5 L. Ed. 128, indicated that it felt there was nothing of substance to the transactions by which Hobac disposed of petitioners' claims as creditors (R. 109, 130-131; App. A19).

When it is remembered that the mill and related properties had no such cash value, but the best offer received by Hobac for such property was the receipt of long-term notes, bearing a small rate of interest and which were not negotiable as shown by the Findings of Fact of the Tax Court, would not any individual see why readily salable timberlands were used to satisfy the capital interests of petitioners as stockholders? Under the terms of the Collateral Loan Agreement executed by Hobac with the Bank, and petitioners, as creditors of Hobac, the funds received from these notes were not to be applied toward payment of petitioners' claims as creditors until such time as the Bank had been paid in full. This is why such notes were required to be held in escrow and why petitioners were not able to exercise control or ownership over such notes.

In its recent opinion in *Knetsch* v. *Commissioner*, *supra*, this Court stated that the trial court's findings "that there was no commercial economic substance to the * * * transactions" and "no economic gain could be achieved from the purchase of these bonds without regard to the tax consequences * * * " were conclusions of law which were reviewable by this Court. Under such ruling, the implications by the Tax Court and Court of Appeals in the instant cases that the transactions between Hobac, Betz-Tipton, and petitioners, as creditors, had no economic consequences and were of no substance are thus matters which are properly reviewable by this Court.

The decision of the Court of Appeals affirming the decision of the Tax Court has so far extended the doctrine

of constructive receipt of income that serious questions will in the future arise as to the receipt of income by other taxpayers. The Regulations propounded by the Treasury Department and which have been in effect over forty years have been disregarded in the formulation of these decisions in the lower courts and this Court's power of supervision should be used to review the questions presented herein.

In addition, the Court of Appeals for the Sixth Circuit has drawn strikingly different conclusions of law in these cases than did the Court of Appeals for the Seventh Circuit in the case of *McLaughlin* v. *Commissioner, supra.* The only means of settling these questions which are of importance, not only to petitioners but to all taxpayers, is for this Court to grant the relief prayed for herein.

PRAYER.

Petitioners, therefore, respectfully pray that a writ of certiorari issue out of and under the seal of this Court, directed to the United States Court of Appeals for the Sixth Circuit, commanding that Court to certify and send to this Court for its review and determination on a day certain to be therein named a full and complete transcript of the record and proceedings in the case entitled on its docket: *O. D. Bratton et al., Petitioners,* v. *Commissioner of Internal Revenue, Respondent,* No. 14,062, to the end that said case may be reviewed and determined by this Court, as provided by Section 1254 of Title 28 of the United States Code and the applicable rules promulgated by this Court governing applications for certiorari in civil cases, and that the judgment of the Court of Appeals in these consolidated proceedings be reversed by decree of this Honorable Court adjudicating that respondent is entitled to no recovery against any of these petitioners and reliev-

ing petitioners of all liability for costs, and that petitioners have such other and further relief in the premises as to this Honorable Court may seem right and proper.

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CERTIFICATE OF SERVICE.

I, WALTER P. ARMSTRONG, JR., a member of the Bar of the Supreme Court of the United States of America, certify, in conformity with Rule 23 of that Court, that a copy of the foregoing petition was served upon Respondent, Commissioner of Internal Revenue, pursuant to Rule 33 of that Court, by mailing, by regular U. S. mail, postage prepaid, to the Office of the Attorney General of the United States, counsel of record of the Respondent, this ..... day of February, 1961.

WALTER P. ARMSTRONG, JR.,
Attorney for Petitioners.